Investment Odds - Know The Number

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In Iceland, there is a sign near one of its famed hot springs that announces, “You are here at your own risk.” In big, bold letters it proceeds to list seven warnings about the dangers of the geysers and how badly one can get burnt. Finally, in a stroke of genius at the eighth bullet point, it states simply, “The nearest hospital is 62 km away.” Let’s think about the ruthless efficiency of that for a moment—it’s effectively stating, “Look, if you haven’t processed a word of these cautions, just know that you’re going to be in serious agony for a long time if you try to get cute.” Perhaps the stock market should come with a similar warning?

No One is Pricing the Risk of Failure

Words, by their very nature, carry connotations. With regard to the sign in Iceland, that final line hits people from the opposite angle of the first seven for a very specific reason. The authors knew that the opening list describing the risks of the geysers would resonate with most people. But, wisely, they also knew that a certain slice of the population would only see the list as a spoilsport, nagging harridan trying to ruin their fun. That was the connotation heard by their ears. Thus, the need for a different tack those people would actually appreciate.

In the investment world, connotations also play a very important role. Words like ‘aggressive’ or ‘opportunistic’ take on unintended meanings, particularly when compared to traditional counterparts such as, ‘conservative’ or ‘stable value’. Blame it on Mountain Dew, Extreme Sports or on the general Hollywood-ification of people’s attitudes towards risk. For better or worse, swinging for the fences appears macho. In actuality, however, those investment terms are merely different names for number values and nothing more.

Yet such attitudes lead to another, more insidious unintended consequence: a one-directional assessment of risk. The first seven warnings on that sign address the situation prior to any potential injury. That’s what a warning is, after all. But the eighth warning? That addresses the aftermath of any mishap. In effect, investors are only focusing on the upside—the potential for outperformance—without accounting for the potential for underperformance.

This is human behavior bias at work and it causes investors to accept a risk they have no idea they’re taking. Perhaps they should simply avoid the losers?

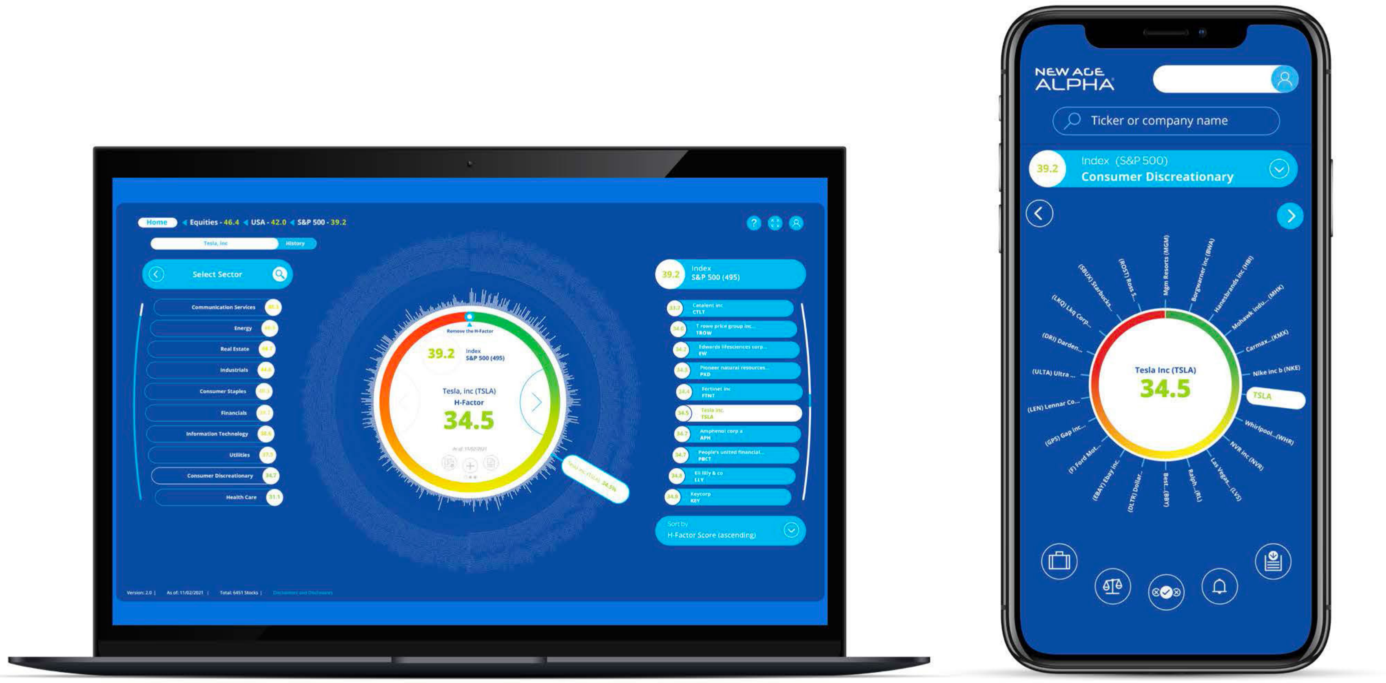
Know the Number

If one were to imagine a true assessment of risk, a good example might be the signage at the top of a Black Diamond ski slope. Sure, the traditional sign should be warning enough. But what if they put a probability number to one’s chances of catastrophic injury? Suddenly this would force the intrepid skier to reprice their risk tolerance. As an example, (though well-scrutinized data is hard to achieve) anecdotal evidence points to a 0.3% chance of injury for most skiers. That number is almost certainly higher on the Black Diamond slopes, though. Upon hearing such a number, one’s risk of failure suddenly hits closer to home. Is a 1% chance of injury still worth a run? How about a 5% chance? Immediately, the cost-benefit is reversed and it’s more important to quantify the possibility of loss than potential enjoyment.

Taking this one step further, the follow-up question seems obvious: How would this apply to the investment world? What are the odds of failure at the average investment house? The truth is: no one knows! That's because outperformance vs. the benchmark is the standard measuring stick. The theoretical risk-free rate of return assumes some level of return in the positive sphere no matter what. But, as has been shown in the market over and over, what an investor thinks will happen...*doesn't necessarily happen*. In effect, Wall Street only prices the upside, not the downside. No one is pricing the risk of failure.

At New Age Alpha, we believe investors deserve to know both. Unlike other managers that rely on a manager's stock picking and a leap of faith, we've developed the Human Factor and the h-factor System. The Human Factor measures the probability a company will fail to deliver the growth implied by the stock price. This risk is caused by investors interpreting vague and ambiguous information and impounding it into a stock's price in a systematically incorrect way. The lower the Human Factor, the more likely vague and ambiguous information has NOT been priced into the stock. The h-factor System is a comprehensive portfolio tool that enables investors to apply our Human Factor metric to over 4,000 stocks, ETFs, global indexes, and their own portfolio.

In practice, we believe the Human Factor and the h-factor System allow investors to make much more informed choices regarding their portfolio construction. In this manner, we—and our investors—can manage risk like an actuary, not like a portfolio manager. Rather than attempting to pick winners, we simply aim to avoid the losers. It is an approach rarely seen on Wall Street...one that allows investors to weigh both the potential upside and the potential downside.



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About Us

New Age Alpha is ushering in a new age of asset management by applying an actuarial-based approach to investment portfolios. Utilizing these principles built by the insurance industry, we construct portfolio solutions, indexes, and tools that aim to identify and avoid a mispricing risk caused by investor behavior. Embedding well-established principles of probability theory in our investment methodology, we construct solutions that aim to avoid overpriced stocks in a portfolio—losers. We combine the alpha potential of active management with the advantages of rules-based investing to build differentiated equity and fixed income portfolios that drive long-term outperformance.

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